283. Several commenters oppose limiting exogenous cost treatment to economic cost changes beyond the LECs' control, arguing that treating accounting cost changes endogenously might prevent LECs from recovering their true economic costs.[537] SWB asserts that it would be contradictory for the Commission to regulate the LECs based upon GAAP accounting, but to ignore the effects of future GAAP changes.[538] Pac Bell argues that, unless the Commission eliminates all vestiges of rate-of-return regulation from its price cap program, the Commission should continue to treat as exogenous changes to GAAP and the Commission's Part 32, 36 and 69 rules.[539] Pac Bell asserts that limiting exogenous cost treatment to "economic" cost changes might be difficult because there is disagreement among economists regarding how to determine "economic costs."[540]

284. NYNEX requests exogenous treatment for GAAP changes whenever LECs lack control over the event triggering the incremental cost change, rather than lack of control over the level of the underlying costs themselves.[541] GTE asserts that the LECs should not be required to absorb costs mandated by regulatory or legislative action that requires them to make uneconomic investments.[542]

285. US West advocates the elimination of exogenous cost adjustments after the expiration of existing adjustments. US West argues that they are a deviation from price cap regulation and that they undercut efficiency incentives. US West suggests that the rules could be modified or waived for events that have a dramatic effect on the telephone industry.[543]

286. WilTel and Ad Hoc recommend extending exogenous cost treatment only to economic costs directly attributable to regulatory actions that specifically and uniquely affect the

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[537] NYNEX Comments at 57; Bell Atlantic Reply at 20-22; USTA Comments at 85-86; GTE Reply at 37; RTC Comments at 22; BellSouth Comments at 55-56; Sprint Comments at 18-19; Ameritech Comments at 18-19; SNET Comments at 14.

[538] SWB Comments at 52-53.

[539] Pac Bell Comments at 53-55; Pac Bell Reply at 53.

[540] Pac Bell Comments at 54.

[541] NYNEX Comments at 62.

[542] GTE Comments at 78.

[543] US West Comments at 18-19.

LECs.[544] In response, NYNEX asserts that the ETI proposal, on which Ad Hoc bases its recommendation, is conceptually flawed. According to NYNEX, the ETI proposal seeks to make exogenous cost treatment similar to the manner nonregulated firms in competitive industries pass on costs in their rates, but does not seek to eliminate other aspects of the LEC price cap plan which NYNEX believes does not mirror the behavior of nonregulated firms.[545]

287. MCI believes that exogenous costs should be limited to Commission-ordered changes that result in a shift in costs between interstate and intrastate jurisdictions or between regulated and non-regulated operations. MCI says that this standard, by definition, would capture cost changes resulting from amendments to Parts 32, 36, or 64 of the Commission's Rules, but only if the cost changes produce a jurisdictional shift.[546] MCI argues specifically that all tax law changes, including industry-specific taxes, should be treated endogenously, contending that such tax changes are reflected in GNP-PI.[547] GTE asserts that the Commission has already rejected an argument by MCI that increased utility-specific taxes should be denied exogenous treatment absent a specific showing that the tax change is not reflected in the GNP-PI.[548]

288. AT&T and MCI request the Commission to treat fully amortized equal access network reconfiguration costs as exogenous costs.[549] AT&T asserts that the amortization of LEC equal access

[544] WilTel Comments at 27; Ad Hoc Comments at 25-27. See also OCCO Comments at 10 (favoring elimination of the exogenous cost mechanism but, if it is retained, urging limitation of the mechanism to material factors impacting the LEC exclusively).

[545] NYNEX Reply at 54-56.

[546] Accordingly, MCI would treat as endogenous the completion of the amortizations of inside wire and the depreciation reserve deficiency, Transitional Support Fund obligations, all tax law changes, regulatory fees, and the discretionary category "other." MCI would treat equal access cost amortization exogenously, and would treat changes in the USOA or GAAP exogenously to the extent they meet the proposed test. MCI Comments at 42-48.

[547] MCI Comments at 43.

[548] GTE Reply at 40, citing Bell Atlantic Telephone Companies, 7 FCC Rcd 2165 (Com.Car.Bur. 1992).

[549] AT&T Comments at 46-48; MCI Comments at 47-48.

costs was completed on December 31, 1993.[550] NYNEX says that the Commission has already rejected this proposal in the 1994 Annual Access Order.[551] BellSouth argues that the amortization of equal access costs should be endogenous because it does not result from shifts of costs between jurisdictions or between regulated and nonregulated operations.[552] US West states that AT&T and MCI base their arguments on the incorrect assumption that LECs no longer incur equal access costs.[553] USTA asserts that, because the Commission has treated all equal access costs as endogenous, including those incurred after the start of price caps, it cannot now treat the expiration of the amortization of equal access network configuration costs as exogenous.[554]

289. CCTA recommends that the Commission continue to treat depreciation rate changes endogenously, to ensure that the LECs do not use accelerated depreciation to finance their video dialtone services.[555] BellSouth recommends eliminating exogenous treatment of inside wire amortization and depreciation reserve deficiencies approved by the Commission at the time price caps were initiated, because those amortizations are now completed. BellSouth also recommends, however, that if the Commission recognizes depreciation reserve deficiencies in the future and permits their amortization, such amounts should qualify for automatic exogenous treatment under Section 61.45(d)(1)(i) of the Commission's Rules, 47 C.F.R. § 61.45(d)(1)(i).[556]

290. CBT recommends preserving the current exogenous cost rules as part of the optional incentive regulation designed for small and mid-sized LECs, if the exogenous cost rules are revised.[557] Conversely, Bell Atlantic supports applying the same

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[550] AT&T Comments at 46-48.

[551] NYNEX Reply at 59-60, citing 1994 Annual Access Tariff Filings, CC Docket No. 94-65, 9 FCC Rcd 3519, 3535-36 (Com. Car. Bur. 1994) (1994 Access Order).

[552] BellSouth Reply at 29-30.

[553] US West Reply at 32-33.

[554] USTA Reply at 64. See also BellSouth Reply at 30.

[555] CCTA Comments at 2, 7-8.

[556] BellSouth Comments at 56.

[557] CBT Comments at 3, citing Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, CC Docket No. 92-135, 8 FCC Rcd 4545 (1993) (Small Company Order); Section 61.50 of the Commission's Rules, 47 C.F.R. § 61.50.

exogenous cost standards to all price cap LECs.[558]

291. OCCO, MCI, and ICA support the adoption of a new administrative process designed to give access customers and other groups the right to identify exogenous cost reductions.[559] ICA recommends requiring LECs to obtain approval for exogenous cost changes prior to the price cap tariff year.[560] NYNEX, USTA, BellSouth, and SWB say there is no need to adopt a new administrative process to allow access customers or other groups to request cost changes eligible for exogenous treatment because the current rules do not preclude any party from petitioning the Commission on matters related to exogenous cost treatment.[561] SWB and Pac Bell assert that the majority of the exogenous adjustments that were made based on changes in the levels of accounting costs have resulted in reductions in price cap indexes.[562] Ameritech avers that a mechanism that would allow customers to seek rate changes outside the context of a complaint of allegedly unreasonable rates would be inconsistent with the concept of carrier-initiated rates.[563]

3. Analysis

292. We tentatively conclude that, for the long term, the best approach to determining and calculating those costs which should receive "exogenous" treatment would be to adopt a price cap formula that recognizes such costs in the X-Factor. A properly designed X-Factor, such as one that is derived from a sound TFP, would recognize almost all of the costs for which exogenous treatment would now be accorded, leaving exogenous cost treatment requests only to cost changes which are truly unique to individual LECs. In the interim, however, we are faced with the issue of whether we can make the exogenous cost rule more consistent with the efficiency incentives price caps intended to produce without creating conditions in which rates would be unreasonably high or low. We believe that, by adopting a third prong to our exogenous cost test for cost changes resulting from changes in USOA requirements, we can improve on efficiency

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[558] Bell Atlantic Reply at 20-22.

[559] OCCO Comments at 11; ICA Comments at 18; MCI Comments at 49.

[560] ICA Comments at 16-17.

[561] NYNEX Comments at 63; USTA Comments at 87; BellSouth Comments at 57; SWB Comments at 54.

[562] SWB Comments at 53; Pac Bell Comments at 54.

[563] Ameritech Comments at 19.

incentives without resulting rates being unreasonably high or low.

293. In the Notice, we stated that we thought certain accounting changes resulted in only a change in how books are kept and costs are recorded, not in an economic cost change that might be expected to affect prices in competitive markets. Thus, we asked whether we should limit exogenous cost treatment for accounting rule changes to the economic cost of those changes to the LECs. Although most parties to this proceeding voiced more extreme views on either side of our proposal,[564] we believe that our original proposal strikes the best balance between promoting efficiency incentives and ensuring that the price cap formula does not lead to unreasonably high or low rates. Therefore, we will limit exogenous cost treatment of cost changes resulting from changes in USOA requirements to economic cost changes caused by administrative, legislative, or judicial requirements beyond the control of the carriers which are not reflected in the GDP-PI.

294. We believe the economic cost standard will narrow the exception exogenous cost treatment represents to the general principle that, under price caps, cost changes do not flow directly into rate changes. By narrowing this exception, efficiency incentives should improve. We select the economic cost standard because we believe it most fully comports with our reason for adopting exogenous cost treatment: to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates. That is, as explained more fully below, when an accounting change that otherwise meets the existing standards for exogenous treatment also affects cash flow, carriers will be able to raise PCIs to recognize this effect. Without a cash flow impact, carriers will not be able to raise PCIs to recognize an accounting change. Moreover, we believe that this result will produce correct pricing signals in the local telecommunications marketplace. Economic cost is the proper measure for guiding resource allocation decisions that will maximize net economic benefits.

295. Although Pac Bell suggests that economic cost is an inappropriate standard, we cannot agree. Most economists agree that an economic cost is the minimum payment necessary to attract

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[564] Most LECs argued that we should not make the exogenous cost standard any stricter. See e.g., GTE Comments at 78; NYNEX Comments at 57. However, other parties, such as IXCs and consumer groups, argue for a stricter exogenous cost standard. See e.g., WilTel Comments at 27; Ad Hoc Comments at 25-27.

is based on the concept of opportunity cost -- the foregone benefits that would be produced if a resource were applied to its next best use instead of its current use. Opportunity costs may be difficult to measure in some contexts, but we are concerned here solely with the effects of changes in accounting rules. We conclude that for this purpose, a change in accounting rules that has an impact on a LEC's discounted cash flow represents a change in the LEC's economic costs and should be eligible for exogenous treatment. We believe that any changes in LEC opportunity costs attributable to changes in accounting rules will be reflected in changes in discounted cash flows. Conversely, an accounting change that does not affect a LEC's discounted cash flow does not represent a change in the LEC's economic costs and should not be eligible for exogenous treatment. Thus, we will require LECs seeking exogenous treatment of accounting cost changes to show that their cash flows have changed due to the accounting cost changes.[566] We emphasize, however, that we are deciding here only the use of the economic cost standard to assess the effects of changes in accounting rules. We are not addressing the use of this standard in other contexts.

296. Viewing this issue from the perspective of an investor illustrates the appropriateness of the standard we are adopting for assessing the eligibility of accounting rule changes for exogenous treatment. The value of a firm in equity markets (i.e., the price of the firm's stock) is based on the discounted cash flow (DCF) of all future payments by the firm to the shareholders. These payments, in turn, are based on the net value of streams of cash payments to and from the firm.[567] If an accounting change has no impact on a LEC's cash flow, an investor will earn the same return before and after the change, all other things being equal, and the value of the investors' equity will be unchanged as well. Thus, we find no public interest argument for changing the LEC's PCI in response to an accounting change that does not affect cash flows.

297. A number of LECs argue that, because their regulation is based on accounting costs, failure to recognize accounting cost changes exogenously might preclude them from recovering

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and R. Tollison, Economics Fourth Edition 4 (4th ed. 1994).

566 We note that a number of LECs recognize the relationship between economic cost and cash flow. See e.g., SWB Comments at 52; Pac Bell Comments at 54-55.

567 For a more detailed explanation of these principles, see generally R. Brealey and S. Myers, Principles of Corporate Finance (2d ed. 1984).

their "true economic costs."[568] GTE and BellSouth contend that we should continue to treat all accounting cost changes exogenously because the initial price cap rates were based on rates based on accounting costs under rate-of-return regulation.[569]

298. Our decision to retain this aspect of cost-plus regulation was appropriate for the beginning of the transition from rates based on regulatory accounting costs to rates that approximate the prices that would be produced in a competitive market. Exogenous treatment allowed the orderly completion of processes begun under rate-of-return regulation, such as the amortization of depreciation reserve deficiencies and the phasing-in of changes in the Separations Manual. It also avoided unfairly penalizing or rewarding carriers for uncontrollable cost changes during the first few years of price caps, when the prices they could charge were still strongly influenced by the initial rates established under rate-of-return regulation.

299. As time goes on, however, the rationale for continuing to allow exogenous cost changes to price cap rates is less compelling. As the pricing flexibility afforded by the price cap plan increasingly allows LECs to adjust rates to track economic costs, and to respond to competitive challenges, the link between current prices and the initial price cap rates should become more tenuous. This progress towards market-based rates, and away from rate-of-return regulation, will be impeded, however, if we continue indefinitely to allow exogenous cost adjustments that have the purpose and effect of perpetuating the relationship between accounting costs and rates that existed on July 1, 1990.

300. Moreover, we find these parties' analysis seriously incomplete. While the initial rates under price caps were indeed based on accounting costs, so too were the studies that led to the Commission's choice of the X-factor. A full analysis must establish both the extent to which the initial rates would have been different under the revised accounting rules, as well as the change in the X-factor and the effects of its application over the past four years. The same accounting changes that could be shown to have affected the initial rates for price caps would also affect the earlier data points used to estimate an X-Factor. A full analysis must take these X-Factor effects into account as well. For example, in theory, an accounting change that would have <u>raised</u> initial rates might also have raised the estimated X-Factor, potentially leading to <u>lower</u> rates today. No party has submitted a full analysis of these effects. Moreover, such a

568 GTE Reply at 37-38; SWB Comments at 51-53; Bellsouth Comments at 55.

569 GTE Reply at 37; Bellsouth Comments at 55.

full analysis would be extremely complex and produce uncertain results, and thus could be impractical for either the Commission or the carriers to undertake.

301. SWB asserts that eliminating exogenous treatment of GAAP changes that require shifts from cash to accrual accounting could prevent recovery for the costs of a service at the time the service is provided.[570] We find this argument unpersuasive. It is a basic feature of price caps that most changes in the current cost of providing service are treated endogenously, that is, are not directly reflected in current prices. Even if, for example, accruals for future OPEB liabilities should be considered a current cost of providing service, it is consistent with the incentive structure of price caps to limit exogenous treatment of those accruals.

302. GTE argues that we should retain exogenous cost treatment for accounting cost changes because many LECs are still regulated based on accounting costs in many state jurisdictions.[571] Our treatment of accounting costs for interstate ratemaking purposes should have no effect whatever on state treatment of those costs. Also, we are continuing to treat cost changes resulting from Part 36 changes exogenously, at least on an interim basis. As a result, we conclude that differences in Federal and state regulations should not require us to treat accounting cost changes resulting from revisions in GAAP exogenously.

303. We decline to adopt, for this interim period, MCI's recommendation that we base our determinations regarding exogenous cost treatment solely on whether the cost change at issue results in a cost shift between jurisdictions. We defer consideration of this suggestion to the further notice. We also note in this regard that, even if we are able to develop an X-Factor that reflects all or most industry-wide cost changes now treated as exogenous, there may still be policy reasons to continue exogenous treatment of changes to the Separations Manual.

304. NYNEX recommends permitting LECs to treat exogenously any costs triggered by an event outside the carrier's control, regardless of whether the costs themselves are within the carrier's control. Similarly, GTE asserts that costs triggered by regulatory or legislative action that requires LECs to make uneconomic investments should be exogenous.[572] Such treatment

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[570] SWB Comments at 52.

[571] GTE Reply at 37-38.

[572] GTE Comments at 78.

would blunt the incentives to become efficient that led us to adopt price cap regulation. In the LEC Price Cap Order, we decided not to permit exogenous treatment of all "extraordinary" costs because it would reduce the carrier's need to be efficient and innovative.[573] We have found that the ability to cope with unforeseen events is at least in part a function of a carrier's managerial decisions, and that permitting exogenous treatment for such unforeseen events removes the incentive to operate more efficiently.[574] We also observe that firms subject to competition also face the risk that they will be required to make investments to satisfy legal or regulatory requirements and that they will not be able to raise prices to recover those investments. Neither GTE nor NYNEX has persuaded us to reconsider these conclusions. Accordingly, we will continue to treat these costs endogenously in most cases.[575]

305. Nor have AT&T and MCI persuaded us to treat as exogenous amortized equal access costs. In the 1994 Annual Access Order, the Bureau found that such treatment would "undercut the Commission's goal that the rates permitted under the price cap indexes be driven by competition and market economies."[576] AT&T also raised this issue in an application for review of the 1994 Annual Access Order. We conclude that the record in that proceeding would provide a better basis to consider this issue, and accordingly, we will not act on this issue here. BellSouth's concerns regarding exogenous treatment of amortization of depreciation reserve deficiencies which may be permitted at some time in the future is speculative. We need not determine whether such amortization will be permitted exogenous treatment unless and until we decide whether to permit amortization at all.

306. In applying our new standard on a prospective basis, we believe that most accounting changes will not have an economic cost associated with them. Accounting changes often have no direct impact on the cash flow choices available to LECs or any other company. Financial accounting books are designed primarily

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[573] LEC Price Cap Order, 5 FCC Rcd at 6809-10.

[574] Petition for Waiver of the Commission's Rules to Recover Network Depreciation Costs, 9 FCC Rcd 377, 395 (1993).

[575] When we required LECs to provide 800 database service, we permitted them to treat a portion of their 800 database costs exogenously. Provision of Access for 800 Service, CC Docket No. 86-10, Second Report and Order, 8 FCC Rcd 907, 911 (1993). We do not foreclose the possibility that we may require the provision of other services in the future which may warrant similar treatment.

[576] 1994 Access Order, 9 FCC Rcd at 3535-36.

to give the financial markets an accurate portrayal of the true economics of the corporation. Changes to the accounting books are merely an attempt to make the portrayal more accurate, not necessarily an attempt to make the company behave differently.

307. Applying this new standard prospectively, it appears that a large part of the accounting changes resulting from the adoption of SFAS-106 may not represent economic cost changes. LECs are not required to change their OPEB commitments to employees, but merely to change the timing of the recognition of these costs on their books.[577] That is, although accounting books may have changed, the LECs had the option of leaving cash flow unchanged. Unless LECs' cash flows were altered because of SFAS-106, we believe that SFAS-106 has had little or no effect on the opportunity cost and economic cost to LECs. Thus, it appears that most if not all of the ongoing cost changes resulting from the adoption of SFAS-106 will not be eligible for exogenous treatment under our revised rule on a prospective basis. Although this does not affect our pending investigations of exogenous cost claims based on OPEBs, LECs that believe that future accounting changes from SFAS-106 are entitled to exogenous treatment should follow the procedures, described below, for requesting such treatment under the revised rule.[578]

308. Consistent with our new rule, we also conclude that LECs must adjust their PCIs to exclude prospectively any accounting cost changes currently reflected there for which

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[577] OPEBs Order, 8 FCC Rcd at 1037. In the OPEBs Order, the LECs submitted two studies purporting to show that SFAS-106 was not reflected in GNP-PI. One of those studies, the Godwins study, assumed that SFAS-106 resulted in an economic cost change. OPEBs Order, 8 FCC Rcd at 1034. In sharp contrast, the NERA study assumed that adoption of SFAS-106 does not change the LECs' economic costs. Id. We found that "[n]either study proves that its initial assumptions are in fact correct . . . ." Id. The court criticized the Commission for not adequately explaining why we found the initial assumptions of either study unproven. Southwestern Bell, 28 F.3d at 171-72. Although the court stated that the NERA study is not completely unsupported, id., it did not reach a conclusion on whether SFAS-106 resulted in an economic cost change or an accounting cost change. Therefore, we find that Southwestern Bell does not preclude a finding that adoption of SFAS-106 did not result in an economic cost change.

[578] We note that the court's decision in Southwestern Bell does not preclude our new rule. Indeed, the court there stated that, "whatever the intrinsic merits [its] bases for rejecting exogenous cost treatment, the Commission is free to consider them as a basis for amending its current rule . . . ." (emphasis in original). Southwestern Bell, 28 F.3d at 173.

carriers did not incur an economic cost, as defined above. For example, when we incorporated SFAS-106 into the USOA, we required carriers to amortize OPEB TBO amounts over periods of up to 20 years beginning on January 1, 1993.[579] Although we denied exogenous treatment to these costs initially, we invited LECs to make a further showing that the TBO amounts were not already reflected in the GNP-PI, and thus, that their PCIs should be adjusted by TBO amounts.[580] Subsequently, almost all of the LECs refiled tariffs including information to support inclusion of their TBO amounts in their PCIs. Although the tariffs were suspended for one day, they were allowed to take effect thereafter.[581]

309. Under the existing rule, the increase in LEC PCIs would be eliminated, i.e., the PCIs would be reduced, at the end of the amortization period because the LECs would have had the opportunity to fully recover these costs by that point in time. We have concluded here that OPEB cost changes are noneconomic cost changes, and thus, should not be reflected in carriers' PCIs prospectively. The tariffs in which TBO amounts were included have taken effect.[582] As a result of the tariffs taking effect, the LECs' PCIs increased by a certain percentage of the amortized TBO amounts, e.g., increased by one-twentieth, to permit recovery of the amortized amounts over the amortization period, e.g., twenty years. If we take no action today to remove those cost changes, the PCIs in the future would be inconsistent with the new rule. Thus, LECs must now adjust their PCIs downward to eliminate those amounts from prospective rates. Specifically, each LEC will be required to reduce its PCI by an amount equal to its original exogenous cost increase made pursuant to SFAS-106 for OPEB TBO costs. We require LECs to make this PCI adjustment in their next annual access tariff filing. This action is prospective only; it does not seek to reclaim revenues obtained up to this point under the LECs' filed tariffs. Those rates are subject to the pending tariff investigation, and their lawfulness will be judged under the rule in effect when the tariffs were filed. LECs that believe that any TBO amounts are entitled to exogenous treatment should follow the procedures, described below, for requesting such treatment under the revised rule.

310. Similarly, our pending investigation of Bell Atlantic's exogenous cost claim for cost changes resulting from SFAS-112 will fall under our current rule. Any future requests

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[579] SFAS-106 Order, 6 FCC Rcd at 7560.

[580] OPEBs Order, 8 FCC Rcd at 1037.

[581] 1993 Access Order, 8 FCC Rcd at 4974.

[582] Id.

by a price cap LEC for exogenous cost treatment based on SFAS-112 will be governed by the revised rule.

311. In addition, we recently adopted an accounting change for allowance for funds used during construction (AFUDC).[583] It appears that such an accounting cost change is not an economic cost because it does not appear to affect real economic behavior nor decrease cash flow because of changes in economic costs. However, because we have not fully analyzed the effect of this change in regard to price caps, and because the rule has not gone into effect yet,[584] we will not make a final determination on this issue here.

312. In the Notice, we sought comment on procedures that would help assure that the LEC price cap plan treat cost increases and decreases fairly and consistently, for example by enabling access customers to bring to our attention cost changes which they believe warrant exogenous cost decreases.[585] We noted there that LECs have significant incentives to request exogenous cost treatment for cost changes that might increase their PCIs, but not to request exogenous cost treatment for cost changes that might decrease their PCIs. In that regard, we note that our rules should not result in only one-sided PCI changes. Rather, they should, as they were intended, result in both increases and decreases when warranted. Price cap LECs should decrease their PCIs when they have cost decreases for those categories of costs listed in our current rules. We believe that through the procedural process, we can meet this objective.

313. Currently, our rules list the specific cost changes that we examined in the original LEC price cap rulemaking and concluded should be given exogenous treatment.[586] Other cost

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[583] The Accounting and Ratemaking Treatment for the Allowance for Funds Used During Construction (AFUDC), Report and Order, FCC 95-56 (released February 28, 1995).

[584] See 47 U.S.C. § 220(g) ("Notice of alterations by the Commission in the required manner or form of keeping accounts shall be given to such persons by the Commission at least six months before the same are to take effect."). The Report and Order appeared in the Federal Register on March 6, 1995. Thus, the rule does not take effect until September 6, 1995.

[585] Notice, 9 FCC Rcd at 1699.

[586] These include the amortization of depreciation reserve deficiencies, changes in the Separations Manual, changes in Long Term Support obligations, reallocation of investment from regulated to nonregulated activities, low-end adjustment amounts, inside wire amortization, and sharing. Section 61.45(d)(1) and (2) of the

changes, such as changes in depreciation rates, were considered and excluded from the list, and thus from eligibility for exogenous cost treatment. Changes in these rules, or their application, require a rulemaking or grant of a waiver. In either case, all interested parties would have the opportunity to present and develop the relevant issues. Interested parties also would have the opportunity to review the specific calculation of the amount of cost changes that are found to be exogenous in subsequent LEC tariff filings.

314. In some cases, however, our current rules do not clearly resolve whether a cost change should be treated as exogenous. For example, although tax law changes and other "extraordinary" cost changes are listed in the exogenous cost exception section, exogenous treatment occurs only when the Commission "shall permit or require" such treatment.[587] No procedures are specified for determining whether exogenous treatment should be granted. This procedural vagueness has led to the issue being raised, inter alia, in a rulemaking, waiver petition, request for declaratory ruling, tariff filing, or petition against a tariff filing. Review may also be disjointed, for example when the issue of whether an access rule should be changed is considered in a rulemaking proceeding, but the issue of whether the change should be treated as an exogenous cost change is not raised in that proceeding, and must then be resolved in a further proceeding.

315. In addition, because this procedural lacuna permits LECs to submit these categories of proposed exogenous cost changes as tariff filings, in the hope the Commission will permit the proposed rates to take effect even if the rates are subject to an investigation, the tariff review process is made more cumbersome and more subject to manipulation. For this limited set of cost changes, the Commission or the Common Carrier Bureau must consider both the issue of whether exogenous cost treatment should be granted and of whether the LEC has computed the amount correctly in its PCI calculations. In most other cases, only the latter issue need be addressed in the tariff review process. Moreover, the fact that LECs may request exogenous cost changes in tariff filings creates one-sided incentives that lend themselves to abuse. LECs have strong incentives to request only exogenous cost increases, not those that may be equally valid but would lower their PCIs.

316. To remedy these problems, we believe we should apply consistent procedures for reviewing all proposals for new or revised exogenous costs, preferably in the same proceeding that

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Commission's Rules, 47 C.F.R. §61.45(d)(1) and (2).

[587] Section 61.45(d)(1)(vi), 47 C.F.R. §61.45(d)(1)(vi).

considers the change that might justify the exogenous treatment. Thus, we believe that in all cases where a cost change for LECs may occur, the issue of whether or to what extent that change should also be treated as an exogenous cost change under price caps should be addressed in the same rulemaking proceeding. This procedure will allow all parties to contribute to our consideration of this issue along with the other issues associated with the change, just as they did when we drafted the list of exogenous costs in our current rules. For example, LECs, access customers, and other parties may all seek a rulemaking and participate in it. This procedure should also avoid the need for two separate, overlapping proceedings, one to consider the merit of the change and the second to consider whether the result should be considered exogenous under price caps. If exogenous treatment is found to be appropriate, the new or revised rule would then be included in the list of such changes in our rules.

317. In some cases, a cost change that might warrant exogenous treatment does not arise in a rulemaking. The change may, for example, be the result of a change in state tax law or an accounting change. In this instance, the appropriate procedure will be to seek either a waiver of our rules, in the event the change is not one contemplated by our current rules but the party believes exogenous treatment is nonetheless warranted, or a declaratory ruling, in the event the change is one that may be eligible for exogenous treatment depending upon the particular circumstances. Declaratory ruling would apply, for example, to tax law changes.

318. These procedures should provide a full and fair opportunity to determine whether the proposed adjustment to the price cap index calculations should be granted. LECs, access customers, and other interested parties may request the waiver or declaratory ruling, or participate in the proceeding.[588] At the same time, the procedures do not intrude on the LECs' ability to initiate new or revised rates. The procedures apply to the calculation of price cap LEC PCIs not to tariff rates, and only act to determine the tariff support and notice requirements that apply to new or revised tariff rates. They do not alter the LECs' right and opportunity to initiate rate changes. Moreover, the effect is simply to replace the ad hoc and unclear procedures that currently apply to these categories of cost change, and to conform the procedures with those currently applied to other types of cost changes. Of course, LECs would not be permitted or required to revise their PCIs until the rulemaking, rule waiver process, or declaratory ruling proceeding was completed. We are

[588] For an example of the issues a petitioner should address in seeking a waiver or declaratory ruling, see Petition for Waiver of the Commission's Rules to Recover Network Depreciation Costs, 9 FCC Rcd 377 (1993) and cases cited therein.

revising the price cap rules to reflect these modifications of our exogenous cost procedures.

319. In the Notice, we also suggested that we might require all exogenous cost changes be submitted in the annual access tariff filings, not simply those required to be included by our current rules.[589] On reflection, however, we are concerned that this procedural requirement might unnecessarily delay the implementation of exogenous cost changes even after they have been found to be appropriate. The revised procedures we are adopting to assure an adequate record for determining the cost changes that should be treated as exogenous will also permit consideration of the implementation schedule that should apply in each case.

320. Finally, we conclude that CBT's proposal regarding optional incentive regulation is outside the scope of this proceeding. In the Notice, we did not solicit comments regarding making revisions to that incentive regulation plan. As a result, we have not developed a record in this proceeding that would permit us to consider such revisions. In addition, in a petition for reconsideration of the Small Company Order, USTA has raised the issue of whether to codify exogenous cost rules as part of Section 61.50.[590] As a result, the record in that proceeding provides a better basis on which to consider this issue. Therefore, we decline to revise the optional incentive plan at this time.

C. Sales and Swaps of Exchanges

1. Background

321. A LEC that chooses price cap regulation must convert all of its affiliates that are not average schedule companies to that system of regulation.[591] Once under price caps, a LEC may not revert to rate-of-return regulation, absent a Commission

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[589] See Section 61.45(d)(3) of the Commission's Rules, 47 C.F.R. §61.45(d)(3).

[590] See USTA Petition for Partial Reconsideration and Clarification, August 5, 1993, at 17.

[591] Average schedule companies are small LECs which are permitted to charge rates derived from aggregate exchange carrier data, rather than developing rates based on their actual costs. See Sections 69.605 and 69.606 of the Commission's Rules, 47 C.F.R. § 69.605, 69.606; LEC Price Cap Order, 5 FCC Rcd at 6820.

waiver.[592] These requirements were intended to prevent a LEC from shifting costs improperly from price cap affiliates to rate-of-return affiliates, or from attempting to "game the system" by alternating between rate-of-return regulation and price cap regulation.[593]

322. In the LEC Price Cap Order, we required any company resulting from the merger of a rate-of-return company and a price cap company, or resulting from one company acquiring the other, to file tariffs in compliance with price cap regulation within one year of the effective date of the transaction.[594] The Commission stated, however, that in some cases, the efficiencies created by the purchase and sale of one or two exchanges may outweigh the threat of "gaming the system," and determined that "[s]uch cases might justify a narrow waiver of the all-or-nothing rule."[595] A number of such waivers have been granted.[596]

323. In the Notice, we also observed that these sales of exchanges can improve efficiency and service quality, and can also promote better infrastructure development by placing exchanges in control of another LEC whose business plan reflects a greater commitment to improving service to customers served by

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[592] LEC Price Cap Order, 5 FCC Rcd at 6819. The requirement that all affiliates other than average schedule companies elect the same form of regulation is referred to as the "all-or-nothing" rule. The all-or-nothing rule was upheld in National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993).

[593] LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2706.

[594] LEC Price Cap Order, 5 FCC Rcd at 6821; Section 61.42(c)(2) of the Commission's Rules, 47 C.F.R. § 61.42(c)(2).

[595] LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2706 n.207.

[596] See, e.g., US West Communications, Inc. and Eagle Telecommunications, Inc., FCC 95-4 (released Jan. 5, 1995) (Eagle Order); Citizens Utilities Company, GTE Northwest Incorporated, GTE California Incorporated, DA 94-1396, (Com. Car. Bur., Accounting and Audits Div., released Dec. 6, 1994) (Citizens Order); GTE Southwest Inc., and Pioneer Telephone Co-operative, Inc., DA 94-1365, (Com. Car. Bur., Accounting and Audits Div., released Dec. 1, 1994) (Pioneer Order); GTE Midwest Inc., and Winnebago Cooperative Telephone Association, DA 94-1366, (Com. Car. Bur., Accounting and Audits Div., released Dec. 1, 1994) (Winnebago Order); US West Communications, Inc. and Emery County Farmers' Union Telephone Association, 7 FCC Rcd 6076 (Com.Car.Bur. 1992) (Emery County Order); US West Communications and Gila River Telecommunications Inc., 7 FCC Rcd 2161 (Com.Car.Bur. 1992) (Gila River Order).

the exchange involved in the transaction.[597] We were concerned, however, that the waivers may increase access rates unnecessarily.[598] A waiver that permits a price cap LEC to sell an exchange with relatively high costs and permits the buyer to move the exchange back to rate-of-return regulation, for example, may not reduce the price cap LEC's rates, but may permit higher, cost-based rates to be filed by the buyer. The transaction may also increase burdens on Commission support programs targeted to help small, high-cost exchanges such as the Universal Service Fund (USF) subsidies or the weighting of Dial Equipment Minutes (DEMs) used for jurisdictional separations by small companies.[599] The expectation of obtaining a waiver might also generate unintended incentives, such as encouraging a price cap LEC to postpone modernizing high-cost exchanges that it can sell to a cost-based company.[600]

324. In the Notice, we solicited comment on methods of preventing unintended windfalls and transactions that artificially increase subsidies, without unreasonably restricting efficient sales or swaps of exchanges. Specifically, we requested comment on whether, and how, the process for granting waivers of the price cap rules governing mergers and acquisitions, or the price cap rules themselves, should be revised so as to prevent unreasonable cost shifting and maintain the efficiency incentives of the LEC price cap plan.[601]

2. Comments

325. A number of commenters oppose changing either the rules governing mergers or acquisitions or the process for granting waivers of these rules. They argue that each individual purchase, sale, merger, and acquisition is unique and requires review on a case-by-case basis.[602] PTI and NRTA assert that limiting or denying Commission support mechanisms to acquired

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[597] Notice, 9 FCC Rcd at 1704.

[598] Id.

[599] Id., citing Section 36.125 of the Commission's Rules, 47 C.F.R. § 36.125.

[600] Notice, 9 FCC Rcd at 1704.

[601] Notice, 9 FCC Rcd at 1704 (Baseline Issue 10).

[602] USTA Comments at 93; GTE Comments at 80; US West Reply at 36-37; SWB Comments at 5; BellSouth Comments at 70; RTC Comments at 24; OPASTCO Comments at 3; PTI Reply at 3-5; Ad Hoc Comments at 32.

exchanges would undermine infrastructure development.[603]

326. AT&T, MCI, and NTCA recommend requiring all price cap LECs that sell high cost exchanges to pass the resulting cost savings directly to their customers through an exogenous cost decrease.[604] In addition, MCI proposes requiring LECs either to demonstrate that there will be no effect on interstate access rates as a result of the transaction, or make an exogenous decrease to their PCIs equal to the additional subsidies the purchasing carriers receive from the DEM weighting and increased USF payments.[605] In its reply, BellSouth asserts that the sale of high cost exchanges is within the control of carrier management and therefore does not meet the threshold test for exogenous treatment.[606] USTA and PTI assert that MCI's proposals could unnecessarily discourage transactions that would otherwise have substantial public interest benefits.[607] PTI also notes MCI has made no representation or commitment to lower its rates if access charges decline.[608]

327. NRTA proposes that the Commission allow a rate-of-return LEC to acquire one or more exchanges from a price cap LEC and return them to rate-of-return regulation without a waiver as long as the acquired exchanges have fewer access lines than the acquiring LEC.[609] NRTA also suggests that the Commission allow purchasing LECs to obtain additional USF support without triggering the temporary cap and indexing mechanism, arguing that

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603 PTI Reply at 3-5; NRTA Comments at 4-7; <u>see also</u> USTA Comments at 93 (adoption of a new rule could unnecessarily discourage transactions that would otherwise have substantial public interest benefits).

604 MCI Comments at 61-62; AT&T Comments at 51; NTCA Comments at 9-10. In general, MCI recommends treating as exogenous any cost change that results in shifting costs between jurisdictions. MCI Comments at 42-48. We consider MCI's recommendation in our discussion of Baseline Issue 6.

605 MCI Comments at 61.

606 BellSouth Reply at 30.

607 USTA Reply at 67; PTI Reply at 2.

608 PTI Reply at 3.

609 NRTA Comments at 6.

these sales should not disadvantage other USF recipients.[610]

3. Analysis

328. We find that sales or swaps of exchanges should result in an exogenous adjustment to the price cap carrier's PCI. We recognize that exogenous treatment of cost changes resulting from sales or swaps of exchanges is a limited departure from our general standard for determining exogenous cost changes -- costs incurred by LECs as a result of administrative, legislative or judicial requirements beyond the control of the carriers and not otherwise reflected in GDP-PI.[611] However, we believe that this departure is necessary to maintain consistency with the concept of the price cap plan overall. In the LEC Price Cap Order, we explained that we adopted price cap regulation in part to give LECs incentives to become more efficient and innovative in their provision of services.[612] Our intent was to design a regulatory system that would mirror the efficiency incentives found in competitive markets.[613] We intended this incentive to induce carriers to develop more cost- effective ways to provide service to their customers. We did not intend to induce carriers merely to sell high-cost portions of their operations to rate-of-return carriers that can recover all of their costs from ratepayers. Without more, we do not view such sales as innovations or efficiency gains by price cap LECs which deserve to be rewarded with increased profits. To the extent that price cap regulation may create a perverse incentive for price cap LECs to sell off higher-cost exchanges, requiring a downward exogenous adjustment should correct this incentive.

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[610] NRTA Comments at 6-7. The "temporary cap and indexing mechanism" referred to by NRTA limits growth in the Universal Service Fund during 1994 and 1995 to a rate equal to the rate of growth in working loops. This mechanism was adopted pursuant to a joint board recommendation in December 1993. See Section 36.601(c) of the Commission's Rules, 47 C.F.R. § 36.601(c); Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board, CC Docket No. 80-286, 9 FCC Rcd 303 (1993) (Interim Order).

[611] See Section V.E. of this Order below.

[612] LEC Price Cap Order, 5 FCC Rcd at 6790. As in the LEC Price Cap Order, we do not define "innovation" narrowly to apply only to technological breakthroughs that lead to new services or offerings. Rather, our definition incorporates innovations in management systems, administration, or in any other economic "input" that is used to produce the firm's "output." See LEC Price Cap Order, 5 FCC Rcd at 6790.

[613] LEC Price Cap Order, 5 FCC Rcd at 6790.

329. Recently, US West proposed, in conjunction with a petition for waivers of the study area freeze and of the mergers and acquisitions rule, to make an exogenous cost reduction to its PCI equal to the net interstate revenue requirement reduction resulting from the sale of 43 exchanges to Eagle Telecommunications, Inc. (Eagle).[614] Because these exchanges comprised parts of study areas rather than whole study areas, the transfer of those exchanges to other LECs would have altered the boundaries of US West's existing study areas.[615] It therefore was necessary for US West to obtain six waivers of the rule

[614] US West indicated that, in each of the affected study areas, the PCI adjustment would equal the reduction in net interstate revenue requirements resulting from the sale of exchanges. Letter from Laura Ford, US West, to Kathleen Levitz, Acting Chief, Common Carrier Bureau, August 6, 1993 (US West Aug. 6 Letter); Letter from Laura Ford, US West, to A. Richard Metzger, Acting Chief, Common Carrier Bureau, June 23, 1994 (US West June 23 Letter); Letter from Lawrence Sarjeant, US West, to Kathleen Wallman, Chief, Common Carrier Bureau, January 24, 1995 (US West Jan. 24 Letter).

[615] A study area is a geographical segment of a carrier's telephone operations. Generally, a study area corresponds to a carrier's entire service territory within a state. Thus, carriers operating in more than one state typically have one study area for each state, and carriers operating in a single state typically have a single study area. Carriers perform jurisdictional separations at the study area level. For jurisdictional separations purposes, the Commission adopted a rule freezing study area boundaries effective November 15, 1984. Part 36 of the Commission's Rules, 47 C.F.R., Part 36, Appendix-Glossary, definition of "Study Area." See MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Docket Nos. 78-72 and 80-286, 49 Fed. Reg. 48325 (Dec. 12, 1984) (1984 Joint Board Recommendation), adopted by the Commission, 50 Fed. Reg. 939 (Jan. 8, 1985) (1985 Order Adopting Recommendations). See also Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board, CC Docket No. 80-286, Notice of Proposed Rulemaking, 5 FCC Rcd 5974 (1990) (Study Area Notice). The Commission took that action, in part, to ensure that LECs do not create high-cost exchanges within their existing service territories as separate study areas to maximize high-cost support. See 1985 Order Adopting Recommendations, 50 Fed. Reg. 939, 940. See also 1984 Joint Board Recommendation, 49 Fed. Reg. 48325, 48337. The study area freeze also prevents LECs from decomposing, and recombining, study areas to increase interstate revenue requirements and exchange carrier compensation.

freezing study area boundaries.[616] In each case, the study area waiver was conditioned on US West's compliance with its representation that the exogenous cost reduction would be made.

330. We have a related concern when whole study areas are bought or sold. Because some price cap LECs apply a single PCI to a region containing many study areas, those LECs could increase their returns under price cap regulation by selling off the higher-cost study areas to rate-of-return LECs without making downward adjustments in their PCIs. Hence, price cap regulation could contain a perverse incentive for price cap LECs to sell whole study areas, without corrective action by this Commission. Accordingly, in the future, conditions regarding exogenous cost adjustments related to sales or swaps of exchanges will attach to any necessary waivers of the price cap merger and acquisition rules as well as to study area waivers. We will grant a waiver of the price cap merger and acquisition rules to a rate-of-return LEC buying all or part of a study area from a price cap LEC only on the condition that the selling price cap LEC make a downward exogenous cost adjustment to remove the effects of the transferred properties from price-capped rates that were based, in whole or in part, upon the inclusion of those exchanges within the price-capped study areas, because only then would the waiver be in the public interest.

331. We conclude that requiring an exogenous cost decrease equal to the increase in subsidies the purchasing carriers receive from the DEM weighting and increased USF payments, as MCI suggests,[617] would not be appropriate. Increases in subsidies paid to the purchasing carrier would not be related to any cost changes experienced by the price cap seller. Rather, the increased amounts paid to the acquiring carrier would reflect the application of the current USF and other rules to the changed circumstances of that carrier. In the case of the US West/PTI transaction, for example, the impact of the sale on the USF was attributable to the cost characteristics of Eagle after the

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[616] US West and Central Utah Telephone, 9 FCC Rcd 194 (Com.Car.Bur. 1993); US West and South Central Utah Telephone Assoc., Inc., 9 FCC Rcd 198 (Com.Car.Bur. 1993); US West and Triangle Telephone Cooperative, Inc., et. al., 9 FCC Rcd 202 (Com.Car.Bur. 1993); US West and Nemont Telephone Cooperative, Inc., 9 FCC Rcd 721 (Com.Car.Bur. 1994); US West and Range Telephone Cooperative, Inc., et. al. 9 FCC Rcd 4811 (Com.Car.Bur. 1994); and Eagle Order. See also Winnebago Order at para. 17; Pioneer Order at para. 17 (GTE stated that it had made an exogenous cost adjustment to reflect the sale of certain exchanges); Citizens Order at para. 20 (GTE stated that it will make such an exogenous cost adjustment).

[617] MCI Comments at 61.

transaction was completed. We originally adopted an exogenous cost mechanism because we were concerned that the price cap formula might, over time, lead to unreasonably high or low rates without such a mechanism.[618] In other words, we did not want the price cap formula to reward or penalize carriers unjustly for certain specific events that are outside their control, and therefore are not the result of increases or decreases in their efficiency.[619] As explained above, sales or swaps of exchanges may result in cost savings which are not really related to efficiency gains, and therefore warrant an exogenous adjustment to avoid rewarding the selling price cap LEC. Increases in USF payments to the purchasing LEC do not unjustly reward or penalize the selling price cap LEC, and therefore do not warrant exogenous cost adjustments.

332. We remain concerned that our current USF and separations rules may unduly encourage the sale of high-cost exchanges by large LECs to small, high cost LECs; create artificial incentives in favor of sales of high-cost exchanges; or create undue disincentives to otherwise efficient mergers that would result in decreased subsidy flows. These concerns existed before we adopted price cap regulation, however, and are not limited to transactions involving a price cap LEC. We therefore conclude that we should defer consideration of USF-based and separations-based incentives to other pending and future proceedings. For example, we have recently released a Notice of Inquiry soliciting comments generally on whether to revise the rules governing high cost assistance from the Universal Service Fund.[620] We will consider some of these issues in that proceeding.

333. We do not conclude at this time that all sales or swaps of exchanges result from perverse incentives created by our price cap regulation. For example, in the Eagle Order, we recently found the particular transaction at issue to have identifiable public interest benefits.[621] Furthermore, many of

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618 LEC Price Cap Order, 5 FCC Rcd at 6807.

619 We specifically declined to extend exogenous treatment to all events outside the carrier's control, because to do so would reduce the carrier's need to be efficient. LEC Price Cap Order, 5 FCC Rcd at 6809-10.

620 See Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board, CC Docket No. 80-286, 9 FCC Rcd 7404, 7410 n.14 (1994) (USF Rulemaking).

621 Eagle Order at para. 19 (Eagle intended to upgrade and modernize the facilities that serve the exchanges at issue). See also, e.g., Gila River Order, 7 FCC Rcd at 2162 (sale resulted in

the transactions we have reviewed did not raise the concerns we identified in adopting the "all-or-nothing rule." Specifically, the parties to the transactions at issue did not seek to maintain both price cap affiliates and rate-of-return affiliates simultaneously. Hence, there was no opportunity to shift costs between affiliates. Nor did those transactions, when examined on a case-by-case basis, appear to create opportunities for carriers to shift back and forth between price cap regulation and rate-of-return regulation.[622] No party suggests that we should discontinue the practice of granting waivers in appropriate cases. Accordingly, we will not revise our rules to discourage or prohibit all sales and swaps of exchanges, or to place new limits on the availability of waivers of the mergers and acquisitions rule.

334. Finally, we reject NRTA's proposal to allow rate-of-return LECs to acquire one or more exchanges from a price cap LEC and return them to rate-of-return regulation without a waiver as long as the acquired exchanges have fewer access lines than the acquiring LEC.[623] Our concerns about using transactions to "game the system" are in no way answered by limiting the sales of exchanges to those with fewer access lines than the acquiring LEC. Such a rule can readily be defeated by dividing a large purchase into a series of small transactions, each of which escapes our review. In light of this risk, and in the absence of anything in NRTA's comments that would lead us to conclude that "gaming the system" need not concern us, we decline to adopt NRTA's proposal.

D. Equalization of Regulations for LECs and CAPs

1. Background

335. Under the AT&T price cap plan, changes in the charges that AT&T pays for access to the LECs' networks are deemed exogenous and, therefore, result in an adjustment to the AT&T

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telephone service to 600 subscribers on Indian reservation who had no access to service previously); Pioneer Order at para. 12. (purchaser intends to, inter alia, begin providing equal access in some exchanges by June 1996, construct 12 new digital central offices, and add fiber for both toll and subscriber use).

[622] See, e.g., Gila River Order, 7 FCC Rcd at 2164; Emery County Order, 7 FCC Rcd at 6078; Golden West Telecommunications Cooperative, Inc., 8 FCC Rcd 6325, 6326 (Com.Car.Bur. 1993); Lynch Corporation, 8 FCC Rcd 7051, 7051 (Com.Car.Bur. 1993).

[623] NRTA Comments at 6.

price cap indexes:[624] Cost changes resulting from an AT&T decision to bypass the local network and cost changes in non-LEC access charges were not made exogenous, however, and thus AT&T does not adjust its indexes for these costs. In the past, we have considered and rejected proposals for treating LEC and CAP access charges alike, because the small scale of CAP services and competition among IXCs would prevent any actual bias in favor of uneconomic bypass of LEC networks.[625] Also, we determined that limiting exogenous treatment to LEC access cost changes created incentives for AT&T to negotiate efficient access arrangements.[626]

336. In the Expanded Interconnection Second Report and Order, the Commission adopted rules requiring Tier 1 LECs,[627] except National Exchange Carrier Association (NECA) pool members, to provide expanded interconnection for switched transport services to all interested parties.[628] In the Notice in this proceeding, we expressed concern that the rules for computing AT&T's exogenous access costs might create an actual bias in the development of switched transport competition.[629] Accordingly, we requested comment on whether our current rules for computing AT&T's exogenous access costs should be revised to equalize the treatment of LEC and CAP access rates in the calculation of

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[624] AT&T Price Cap Order, 4 FCC Rcd at 3005. See also Price Cap Performance Review for AT&T, Report, CC Docket No. 92-134, 8 FCC Rcd 5165, 5168-69 (1993) (AT&T Performance Review).

[625] AT&T Performance Review, 8 FCC Rcd at 5168, citing AT&T Price Cap Order, 4 FCC Rcd at 3037; AT&T Price Cap Reconsideration Order, 6 FCC Rcd at 673.

[626] Id.

[627] Tier 1 LECs are companies having annual revenues from regulated telecommunications operations of $100 million or more for a sustained period of time. Commission Requirements for Cost Support Material to be Filed with 1990 Annual Access Tariffs, 5 FCC Rcd 1364, 1364 (Com. Car. Bur. 1990) (defining Tier 1 LECs using the criteria to define Class A companies in 47 C.F.R. §§ 32.11(a) and 32.11(e)).

[628] See Expanded Interconnection with Local Telephone Company Facilities and Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board, Second Report and Order and Third Notice of Proposed Rulemaking, CC Docket No. 91-141, Transport Phase I, 8 FCC Rcd 7373 (1993); see also Expanded Interconnection with Local Telephone Company Facilities, CC Docket 91-141, 9 FCC Rcd 5154 (1994) (Virtual Collocation Order).

[629] Notice, 9 FCC Rcd at 1703.

AT&T's exogenous access costs.[630] We also requested comment on whether any other rules or policies that relate to LEC price cap regulation should be revised to equalize our treatment of LECs and CAPs.[631]

2. Comments

337. Some CAPs and other commenters oppose revising the exogenous cost rules to equalize the treatment of LEC and CAP access charges imposed on AT&T.[632] Several commenters expect AT&T to continue to purchase the bulk of its switched access from the LECs, and argue that there is no justification for changing the current rules.[633] TCG claims that requiring AT&T to track CAP charges separately and to calculate adjustments to its PCI to reflect changes in CAP rates would create a disincentive for AT&T to use CAP facilities.[634] ICA maintains that competitive pressure is sufficient to force AT&T to pass through access charge reductions in its business service rates. Accordingly, ICA suggests that, if the Commission revises AT&T's exogenous cost rules at all, then the pro-rated percentage change in AT&T's average access cost per minute for all switched services should be used as an adjustment only to the basic MTS services.[635]

338. USTA and many LECs argue that the current rules provide a substantial incentive for AT&T to bypass LEC networks, and recommend that the Commission equalize the exogenous cost treatment of LEC and CAP access charges.[636] US West, Pac Bell, and Ameritech maintain that the CAPs are a significant competitive threat to the LECs, and that the Commission's reason

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[630] Notice, 9 FCC Rcd at 1703 (Baseline Issue 9a).

[631] Notice, 9 FCC Rcd at 1703 (Baseline Issue 9b).

[632] TCG Comments at 13; Hyperion Reply at 8-9; Ad Hoc Comments at 30; AT&T Comments at 46-47.

[633] Ad Hoc Comments at 30-31; TCG Comments at 13; Hyperion Reply at 8-9.

[634] TCG Comments at 13-14.

[635] ICA Comments at 23.

[636] USTA Comments at 89; US West Comments at 58-59; Bell Atlantic Comments at 29; NYNEX Comments at 51; BellSouth Comments at 66-67; Ameritech Comments at 27; Pac Bell Comments at 65-66; GTE Reply at 75-76.